

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:CHI:2:POSTF-116490-02  
MJCalabrese

date: *March 22, 2002*

to: Joe Jason, Internal Revenue Financial Products Specialist, and  
Pat Perrone, Internal Revenue Agent

from: Associate Area Counsel (LMSB), Chicago

---

subject: Opinion - Tax Treatment of a Stripped Bond

Taxpayer: [REDACTED], Inc.

This memorandum responds to your office's ongoing request for assistance on this taxpayer. We are coordinating this matter with Financial Products Industry Counsel Rose Gole and Thomas Kerrigan. This memorandum should not be cited as precedent.

**ISSUES**

1. Whether a bond issued by a Canadian subsidiary and acquired by its US parent should be treated as debt or equity.
2. Whether the US parent's sale of the first five year's of interest coupons to a bank brings the bond under the stripped bond provisions of I.R.C. § 1286.

**CONCLUSIONS**

1. The bond issued by the Canadian subsidiary and acquired by its US parent should be treated as debt.
2. The US parent's sale of the first five year's of interest coupons to a bank brings the bond under the stripped bond provisions of I.R.C. § 1286.

**FACTS**

On [REDACTED], [REDACTED], Inc. purchased a rate reset bond issued and payable by [REDACTED]'s subsidiary [REDACTED]. The instrument had a fixed maturity date of [REDACTED]. On [REDACTED] (five years after issuance), the interest rate

on the instrument was to be reset to a rate tied to the then current Canadian dollar swap rate and the applicable credit spread. Also, on [REDACTED] [REDACTED] had the right to pay off the bond with no penalty (advance payments prior to [REDACTED] were subject to penalty). On [REDACTED], [REDACTED] paid off the balance of the amount it owed under the bond.

Terms of the bond were accompanied by a Recontribution Agreement. In it [REDACTED] agreed that in the event of default, [REDACTED] would reinvest the principal and other amounts owed to it in the common stock of [REDACTED]. If circumstances did not allow [REDACTED] to invest the amount into the subsidiary's stock, the obligation would be treated as super-subordinated debt of [REDACTED]. As super-subordinated debt, it would be treated as subordinate to all existing and future debts of [REDACTED]. If [REDACTED] is insolvent at the time of any default, any amounts received by [REDACTED] pursuant to the terms of the bond would be used to pay debts of, or claims against, [REDACTED].

At the same time that [REDACTED] purchased the rate reset bond, it sold to [REDACTED] the first five years of interest coupons. [REDACTED] kept the principal portion of the bond.

The taxpayer wants to treat the rate reset bond as equity for US purposes and debt for Canadian purposes. It justifies this inconsistent treatment based upon an opinion from a US law firm saying that the bond was equity for purposes of US tax law and an opinion from a Canadian law firm saying that the bond was debt for Canadian tax purposes. The opinions state that US law looks primarily at the substance of the transaction and Canadian law looks primarily at the form.

The examination team is looking at the years [REDACTED], [REDACTED], and [REDACTED]. On its returns for [REDACTED] and [REDACTED], the taxpayer accrued and reported interest income with respect to the bond. It has since filed a claim for refund, stating that no interest should have been reported (because of the taxpayer's theory that the bond interest in [REDACTED] constitutes equity).

## ANALYSIS

### 1. Debt v. equity

On [REDACTED], the taxpayer acquired a bond in exchange for advancing funds to its subsidiary [REDACTED]. The instrument had a face value of \$[REDACTED] Canadian. Contemporaneous with its purchase of the instrument, [REDACTED] sold

to [REDACTED] the bond's interest coupons for the first five years. [REDACTED] wants to treat the bond as an equity interest for US tax law purposes. For Canadian tax law purposes, [REDACTED] treats the instrument as debt.

- a. Pursuant to I.R.C. § 385(c) [REDACTED] is not permitted to recharacterize the bond as equity

In enacting I.R.C. § 385, Congress authorized the Treasury Secretary to prescribe regulations for determining whether an interest in a corporation constitutes debt or equity. However, no regulations under § 385 now exist.

I.R.C. § 385(c) states that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)." Except as regulations provide otherwise, this rule shall not apply if the holder of the interest in the corporation discloses on its return that it is treating the interest in a manner inconsistent with the issuer's characterization at issuance. I.R.C. § 385(c)(2).

In this case [REDACTED] characterized as a bond the financial instrument acquired by [REDACTED]. The bond had interest coupons. (b)(5)(AC), (b)(7)a

[REDACTED]

[REDACTED]. The Service may look at all the relevant facts to determine whether the bond in substance constituted debt or equity.

- b. Evaluation of the facts of the [REDACTED] bond show evidence of both debt and equity; however, on balance the factors suggest that the bond, in economic reality, constituted debt.

Contributions to the equity of a business do not create a debt for purposes of I.R.C. § 166. Kean v. Commissioner, 91 T.C. 575 (1988); Treas. Reg. § 1.166-1(c). Whether a transfer of funds to a business constitutes debt or equity is a question of both fact and law. In the Matter of Larson, 862 F.2d 112 (7th Cir. 1988). Advances from a parent to a subsidiary are subject to close scrutiny as control allows an opportunity for the parent to create a fictional debt. Roth Steel Tube Co. v. Commissioner,

800 F.2d 626 (6th Cir. 1986); In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976). Similarly, the parent can use its control to create fictional equity.

Determining the existence of a bona fide indebtedness depends upon the particular facts of the case. In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. Various courts have considered different tests and relevant factors; however, "in the final analysis . . . the question depends on the facts and circumstances of each case". Kean v. Commissioner, 91 T.C. 575 (1988). The question of genuine debt does not turn on any one factor, and not all factors may apply in a particular case. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980). Assessing the various factors "may often be difficult because it is the result of adding and weighing several elements of a situation some of which may give rise to conflicting inferences." Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).

Courts have identified a number of relevant factors in making a debt or equity determination. In this case, a review of the relevant factors gives "rise to conflicting inferences". Weighing the different factors we have concluded that on balance the facts indicate that the bond constituted debt.

#### **i. Factors suggesting debt**

The parties to the transaction labeled as a bond the security instrument at issue. The name given to the security is a factor in making a debt/equity determination. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). The intent of the parties is another factor. Id. These two factors are related, as the name given to the security is often good evidence of the intent of the parties. See also Clyde Bacon, Inc. v. Commissioner, 4 T.C. 1107 (1945). In this case, the parties are related, making these factors of somewhat lesser significance. Road Materials, Inc. v. Commissioner, 407 F.2d 1121 (4th Cir. 1969); Anchor National Life Insurance Co. v. Commissioner, 93 T.C. 378 (1989); Laidlaw v. Commissioner, T.C. Memo. 1998-232. Nevertheless, the transaction involved [REDACTED]'s issuance of a bond with interest coupons. This suggests debt.

Also considered in making the debt-equity determination is whether the receiver of the funds repaid the advanced amounts. Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984), aff'g T.C. Memo. 1982-314; Estate of Nixon v. United States, 464 F.2d 394 (5th Cir. 1972). [REDACTED]'s manner of treating the bond would also constitute some evidence

of the intention of the parties. A representative of the taxpayer has advised the Service that on [REDACTED], [REDACTED] paid off the bond. It is our understanding that prior to the payoff, [REDACTED] had not been in default on the note, making the required interest payments to [REDACTED]. [REDACTED]'s making timely payments on and eventually satisfying the note constitutes evidence of debt.

A significant factor establishing a debtor/creditor relationship is the existence of a fixed maturity date. United States v. Title Guarantee Trust Company, 133 F.2d 990 (6th Cir. 1943). The lack of a maturity date on a financial instrument constitutes very strong evidence of equity. Wood Preserving Corporation v. United States, 347 F.2d 117, 119 (4th Cir. 1965); United States v. Title Guarantee and Trust Co., 133 F.2d 990 (6th Cir. 1943); Rev. Rul. 90-27, 1990-1 CB 50. The terms of the bond provides for a [REDACTED] maturity date. On [REDACTED], five years after issuance, terms provide for resetting the interest rate. Recomputing interest does not alter the bond's maturity date. The fixed maturity date indicates debt. Terms of the bond allowed [REDACTED] to pay off the bond without penalties on [REDACTED] (five years after issuance). Pursuant to this right, [REDACTED] paid off the bond on [REDACTED].

Another relevant factor for consideration is the source of payments on the obligation. Payments contingent on earnings suggests equity. In re Lane, 742 F.2d 1311 (11th Cir. 1984); Shedd v. Commissioner, T.C. Memo. 2000-292.

The [REDACTED] bond did not provide for payments contingent on earnings. This factor suggests debt.

#### **ii. Factors suggesting equity**

A right to enforce payment of principal and interest suggests debt. Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Canadian law probably provides a bondholder with rights to enforce payment, suggesting debt. However, according to the taxpayer's US counsel, [REDACTED]'s default results in [REDACTED] having either to make a capital contribution to or to pay debts of the subsidiary, which suggests equity.

Though a creditor may have a claim subordinate to other creditors, Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2nd Cir. 1956), subordination may suggest equity when combined with other equity factors, Trans-Atlantic Company v. Commissioner, 469 F.2d 1189 (3rd Cir. 1972); Rev. Rul. 83-98, 1983-2 CB 40. Here, the bond provided for subordination of [REDACTED]'s rights

under the bond.

Another factor looks at whether the receiver of the funds provided security for repayment. In re Lane, 742 F.2d 1311 (11th Cir. 1984). Here we do not know of any security provided by [REDACTED], a factor generally suggestive of equity. Under the facts this case, this factor may not be very significant as it is not usual for bond issuers to also provide the bond holder with security.

**iii. Factors not clearly suggesting debt or equity under the known facts of this case**

The ability of the security holder to participate in management is a factor suggesting equity. Gloucester Ice & Cold Storage v. Commissioner, 298 F.2d 183 (1st Cir. 1962) rev'g T.C. Memo. 1960-195. In this case, the bond did not provide for any rights of management participation; however, the holder of the security was also the controlling shareholder.

Also evaluated in making a debt-equity determination is whether the corporation could obtain credit from outside sources. Electronic Modules Corporation v. United States, 695 F.2d 1367 (Fed. Cir. 1982). We understand that [REDACTED] was a viable, operating company in Canada with good revenues and a good product. We assume that it would have been able to obtain some sort of credit from outside sources; however, the known facts are insufficient i) to make a reasonable determination of the credit terms available to [REDACTED] or ii) to otherwise make a sound determination on this question.

The debt-equity evaluation also looks at how the advanced funds were used. Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984), aff'g T.C. Memo. 1982-314. Use of the funds to acquire a capital asset suggests equity, while use of the funds to meet daily operating needs suggests debt. Here, we do not know how the funds were used.

A shareholder's advance is more likely to be treated as equity when the corporation is thinly or inadequately capitalized. Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984), aff'g T.C. Memo. 1982-314; Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969). Your memorandum to us does not indicate that [REDACTED] Canada was thinly or inadequately capitalized.

Further development of the unknown facts would allow us to make a surer determination as to the economic reality of the bond transaction.

**iv. Other factors and considerations**

In assessing the intent of the parties it may be proper to consider whether the transaction had a tax avoidance purpose, Talbot Mills v. Commissioner, 3 T.C. 95 (1944). But see also Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2nd Cir. 1956) (an admitted tax "minimization" purpose did not defeat the taxpayer's characterization of the transaction). In this case, we assume that [REDACTED] had a business need to acquire funds for business operations. In providing funding for its subsidiary, however, the taxpayer apparently structured the transaction to have it treated as an equity contribution for US tax purposes and as debt for Canadian tax purposes, thereby obtaining accrued interest deductions in Canada without requiring recognition of income in the United States. This effort to obtain deductible accrued interest liabilities in Canada without having accrued interest income in the United States makes more suspicious the purposes of certain actions, such as the recontribution agreement, the subordination terms, and the lack of security.

An advance may initially constitute a loan, only later to become a capital contribution. The lender and borrower may initially have intended to treat the obligation as a loan with periodic payments of interest and a fixed maturity date for payment of principal. Later, when the borrower experiences financial difficulties and is unable to meet its obligations under the loan, the parties may then treat the original advance, or the unpaid amount, as a contribution to capital. See Cuyuna Realty Company v. United States, 382 F.2d 298, 302-302 (Ct. Cl. 1967) ("a parent's advance to a subsidiary may start out as bona fide indebtedness, and may continue as such into insolvency, but the character of indebtedness may vanish when the parent and the subsidiary cease acting like debtors and creditors"); Tampa & Gulf Coast Railroad Co. v. Commissioner, 56 T.C. 1393 (1971); Lease v. Commissioner, T.C. Memo. 1993-493.

(b)(5)(AC), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(7)a

[REDACTED]

[REDACTED] Evaluation of the known facts indicates that in economic reality the bond constituted debt. The Service may properly treat the bond as debt.

## 2. Stripped coupons

I.R.C. § 1286(e)(2) defines a stripped bond as "a bond issued at any time with interest coupons where there is a separation in ownership between the bond and any coupon which has not yet become payable." A stripped bond is treated as a "bond originally issued on the purchase date and having an original issue discount . . . ." I.R.C. § 1286(a). The amount of the original issue discount is

the excess (if any) of-

- (1) the stated redemption price at maturity (or, in the case of coupon, the amount payable on the due date of such coupon), over
- (2) such bond's or coupon's ratable share of the purchase price

I.R.C. § 1286(a).

At the same time that [REDACTED] acquired the bond, it sold the first five year's worth of coupons to [REDACTED]. The stripped bond and the detached coupons are each treated as bonds originally issued on the purchase date at discount.

[REDACTED] may have initially recognized its original issue discount obligations, as it accrued and reported interest with respect to the bond for the years [REDACTED] and [REDACTED] (the years at issue). We understand that the financial products specialist assigned to the [REDACTED] examination is determining the required amount of income inclusion.

[REDACTED] is properly treated as holding a stripped bond. The taxpayer is subject to the provisions of I.R.C. § 1286 and the original issue discount rules.

We are requesting the national office's 10 day post review of this opinion. It is possible that the national office may supplement, revise, or change the advice contained herein. Please do not act on this advice until the national office completes its 10 day review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.



If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

Steven R. Guest  
Associate Area Counsel (LMSB),  
Chicago

By: \_\_\_\_\_  
MICHAEL J. CALABRESE  
Attorney

cc (by e-mail only):

Harmon Dow, Associate Area Counsel (IP), Chicago  
Barbara Franklin, Senior Legal Counsel (LMSB), National Office  
Steven Guest, Associate Area Counsel (LMSB), Chicago  
Thomas Kerrigan, Financial Products Industry Counsel, Brooklyn  
James Lanning, Area Counsel (LMSB), Chicago  
William Merkle, Associate Area Counsel (SL), Chicago